

No. 12,664

IN THE
United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER, and
LILLIE S. WEGEFORTH,
Respondents.

On Petitions for Review of the Decisions of the Tax Court
of the United States.

BRIEF FOR RESPONDENTS.

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12,663.*

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BRIEF FOR RESPONDENTS.

OPINION BELOW.

The opinion of the Tax Court (R. 64-98) together with the concurring opinion (R. 98-101), which represented the views of twelve judges, and the dissenting opinion (R. 102-117), in which three of the judges concurred, are reported at 13 T. C. 984.

JURISDICTION.

These consolidated cases involve asserted deficiencies in individual income taxes for the calendar years 1937-1940, inclusive, or for some of those years in the case of some of the taxpayers. Taxpayers' income tax returns for the years in question were filed in the First and Sixth Districts of California. Notices of deficiencies were mailed to the taxpayers on April 22, 1944 (R. 197-200), May 13, 1944 (R. 220-228), and on May 26, 1944 (R. 13-17, 134-141, 169-178). Petitions for redetermination by the Tax Court of the United States were filed by the taxpayers, pursuant to the provisions of section 272 of the Internal Revenue Code, on June 12, 1944 (R. 6-17, 122-141), July 5, 1944 (R. 155-178), and July 17, 1944 (R. 192-200, 209-228). The decisions of the Tax Court were entered on March 14, 1950 (R. 118, 150-151, 187-188, 205, 236). The Commissioner filed petitions for review by this Court on June 2, 1950 (R. 119-121, 152-155, 189-192, 206-208, 237-240). The jurisdiction of this Court rests on section 1141 (a), Internal Revenue Code, as amended by section 36 of the Act of June 25, 1948.

QUESTION PRESENTED.

Section 115 (a) (1), Internal Revenue Code, defines a dividend as a distribution by a corporation out of its earnings or profits accumulated after February 28, 1913. The question presented is whether the Tax Court was correct in construing this section of the statute to mean that a corporation can have no accumulated earnings or profits available for taxable dividends until an operating

deficit existing on March 1, 1913 has been restored by subsequent earnings.

STATUTES INVOLVED.

These cases involve the construction of the following portion of section 115 (a) of the Internal Revenue Code:

“(a) Definition of Dividend.—The term ‘dividend’ when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913 * * *.”

The applicable provisions of other relevant statutes not set forth in the body of the brief will be found in the Appendix, *infra*.

SUMMARY OF ARGUMENT.

A. Preliminary statement.

B. The Tax Court correctly decided that an operating deficit as of March 1, 1913 must be restored before there are accumulated earnings or profits available for dividends.

1. It is fundamental that there can be no earnings available for dividends while capital is impaired.

2. The Treasury Department follows the general rule.

3. The basis of the government's contention was repudiated by the Supreme Court in the *Canfield* case.

4. The only authorities on the point are contrary to the government's position.

5. Comparison of provisions of earlier statutes shows conclusively that all operating deficits must be restored before earnings or profits are available for dividends.

6. The addition in 1936 of Part (2) of the definition of a dividend does not change the meaning of Part (1).

C. The government's construction raises the question of constitutionality of this section as applied to the facts of this case.

D. Correction of miscellaneous arguments in government's brief.

1. This case does not involve a claim for exemption from tax.

2. The Tax Court's decision does not render any words in the statute meaningless.

3. Government's quotation from *Foster* case is misleading.

E. The cases primarily relied upon by the government are not in point.

A. PRELIMINARY STATEMENT.

The question involved which is determinative of these cases is whether the earnings or profits of J. D. and A. B. Spreckels Company available for dividends were increased by approximately \$5,000,000 as a result of the liquidation

of Oceanic Steamship Company, a wholly-owned subsidiary, in 1936. During its early years Oceanic sustained very heavy operating losses but it was more successful in later years and finally at the time of its liquidation in 1936 it had succeeded in making up the early losses so that it had a small earned surplus. It is admitted that this earned surplus was transferred to the Spreckels Company upon the liquidation of Oceanic under the theory of the *Sansome* case (60 F. 2d 931) and became available for dividends by that company. However, the government contends that as a result of the liquidation of Oceanic the earnings and profits of the Spreckels Company available for dividends were increased by an amount exceeding \$5,000,000. It arrived at this amount by taking into account the earnings of Oceanic since March 1, 1913 and entirely ignoring the fact that prior to March 1, 1913 Oceanic sustained operating losses in the amount of \$4,878,987.40.

The economic fallacy of this position can be illustrated by a simple example: Assume that Oceanic had been incorporated for \$10,000,000 as a wholly-owned subsidiary of the Spreckels Company, that prior to March 1, 1913 it had lost \$5,000,000, and that thereafter it had earned \$5,000,000 and had then liquidated, never having paid a dividend. It is apparent that the Spreckels Company would have broken even in this venture having sustained neither gain nor loss. To argue that its earnings or profits available for dividends were increased by \$5,000,000 is therefore an economic absurdity. If it had sold the stock in 1936 for \$10,000,000 instead of liquidating, its earnings

or profits would not have been increased since no gain or loss would have been realized. The fact that the March 1, 1913 value of the stock of Oceanic would in such case have been \$5,000,000 does not alter this conclusion since section 115 (l) of the Internal Revenue Code (expressly made applicable by section 501 (b) and (c) of the Revenue Act of 1940 to all prior taxable years) provides that for the purpose of the computation of earnings and profits of a corporation gain or loss realized from the sale or other disposition of property shall be determined by using the basis for determining *gain*, which in such case would be the original cost (section 113 (a) (14)). Thus, under the facts supposed above, if the Spreckels Company had sold the stock of Oceanic in 1936 to Matson for \$10,000,000, no gain or loss would have been realized and its earnings or profits available for dividends would have been unaffected. If, however, it had liquidated Oceanic and then sold its assets for \$10,000,000 to Matson, then no gain or loss would have been realized, but the government would have us believe that its earnings or profits available for dividends would be increased by \$5,000,000. The statute should not be construed to produce such an anomalous result unless such construction is unavoidable.

B. THE TAX COURT CORRECTLY DECIDED THAT AN OPERATING DEFICIT AS OF MARCH 1, 1913 MUST BE RESTORED BEFORE THERE ARE ACCUMULATED EARNINGS OR PROFITS AVAILABLE FOR DIVIDENDS.

The question presented depends upon the construction to be given to the following portion of section 115(a) of

the Revenue Act of 1938 and of the Internal Revenue Code:

“The term ‘dividend’ * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913 * * *.”

It is our position that there must be “earnings or profits” before there can be any “earnings or profits accumulated after February 28, 1913,” and that a corporation can have no earnings or profits available for dividends until an operating deficit, whether in existence on March 1, 1913, or arising later, has been restored. It is a contradiction in terms to say that a corporation has accumulated profits when its capital is impaired. The government’s position has been well summarized by the Tax Court in its opinion (R. 71) where it is stated that the government contends “that in computing corporate earnings accumulated after February 28, 1913, regard is to be given only to operating results after that date, and no regard is to be given to the condition or state of the corporate capital on that date.”

The words “accumulated after February 28, 1913” were first added to the statute in substantially the same form in the Revenue Act of 1916. The purpose Congress had in mind in adding these words to the statute is discussed in *Lynch v. Hornby*, 247 U. S. 339 (1918). In that case a company declared dividends of \$650,000 in 1914, of which \$240,000 was paid out of earnings since March 1, 1913, and \$410,000 from profits on sale of property held

on March 1, 1913. Hornby claimed that the latter portion, representing earnings accumulated prior to March 1, 1913, was free from tax. The court held that the entire dividend of \$650,000 was subject to tax. The word "dividend" was not defined in the Act of 1913, although specifically included under the definition of gross income, but the court relied upon its well understood meaning as a distribution from earnings and held that distributions from earnings accumulated prior to March 1, 1913 were included within the meaning of the term. In its opinion the court pointed out that the Revenue Act of 1916 added a provision for the purpose of excluding from the effect of the tax any dividends declared out of earnings or profits that accrued prior to March 1, 1913. This provision (section 2(a)) limited the words "earnings or profits" to "earnings or profits accrued since March first, nineteen hundred and thirteen." The court said that it regarded the change "as a concession to the equity of stockholders granted in the 1916 Act, in view of constitutional questions that had been raised" in the *Hornby* and other cases.

1. It is fundamental that there can be no earnings available for dividends while capital is impaired.

The words "accrued since March first, nineteen hundred and thirteen" must be interpreted in the light of the "concession to the equity of stockholders" which prompted their addition. All that Congress intended was to exempt from the tax dividends from earnings accrued prior to March 1, 1913. There is nothing to indicate that an impairment of capital existing on March 1, 1913 is to be disregarded. The opinion of Judge Murdock in the case

of *Loren D. Sale*, 35 B. T. A. 938 (1937), contains an excellent statement of the necessity of restoring impaired capital before a corporation can have any accumulated earnings available for dividends. After first stating that (page 939)

“There is a rule of law that every impairment of capital or paid-in surplus resulting from operating losses must be restored before any earnings can be available for the distribution of a taxable dividend within the meaning of section 201(a) of the Revenue Act of 1924. * * *”

the opinion contains the following statement (page 941):

“The statute does not provide that impaired capital or paid-in surplus must be restored before earnings are available for the distribution of a taxable dividend. That rule of law was laid down by the Board and the courts, which had in mind *the fundamental principle that a corporation, the capital of which had been impaired by losses, can never have any accumulated earnings until its capital is restored. Corporations, of course, were well known long before March 1, 1913, the effective date of the income tax. Likewise, the concepts of capital and impairment of capital were fixed in the law and generally understood. The provisions of the revenue acts have not changed the law in respect of capital or impairment of capital.* * * *” (Italics added.)

And in its opinion in this case the Tax Court concluded (R. 85):

“From the above, we think it follows that there can be no accumulation of profits until impaired capital has been restored. There is a difference, we

think, between the realization currently of earnings and profits and the accumulation thereof. In other words, *there can be no accumulation of earnings where profits, as earned, are absorbed in restoration of capital which has been impaired through previous operating losses, and it seems to us fundamental that it matters not whether the impairment occurred before or after March 1, 1913. * * **” (Italics added.)

2. The Treasury Department follows the general rule.

The Treasury Department itself, in promulgating its official Regulations relating to the computation of invested capital for excess profits tax purposes under the Revenue Act of 1918 and the Revenue Act of 1921, stated in Article 838 of both Regulations 45 and Regulations 62:

“* * * In the computation of earned surplus and undivided profits recognition should first be given to all expenses incurred and losses sustained *from the original organization of the corporation down to the taxable year * * **. *There can, of course, be no earned surplus or undivided profits until any deficit or impairment of paid-in capital has been made good. * * **” (Italics added.)

In *Willcuts v. Milton Dairy Co.*, 275 U. S. 215, 218 (1927), the Supreme Court quotes the foregoing language from Article 838, and says:

“* * * But it is a prerequisite to the existence of ‘undivided profits’ as well as a ‘surplus,’ that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute ‘undivided profits.’ ”

It is true that this decision of the Supreme Court, as well as the Treasury Regulations just referred to, both deal with the determination of invested capital for excess profits tax purposes but, as stated by the Court of Appeals in *Hadden v. Commissioner*, 49 F.2d 709 (CA-2, 1931), "Congress did not intend that a corporation should be held to accumulate profits for one tax purpose only and not for another. * * *"

The identity between the determination of earnings or profits for invested capital purposes and for the purpose of determining the taxability of corporate distributions is illustrated by the decision in *Troy Record Co.*, 11 B. T. A. 298 (1928). One of the issues involved in this case was whether the Commissioner was correct in reducing invested capital by the amount of \$22,745.20 representing dividends paid in 1916, 1917, 1918 and 1919 which the Commissioner determined had been paid out of capital. The corporation, which operated a small newspaper, was organized and began publication in 1896. During the years 1896 to 1905, inclusive, it sustained operating losses. It first began to make money in 1906. The Commissioner determined that the 1896 to 1905 operating losses constituted an operating deficit which he further determined had not been completely restored at the time when dividends amounting to \$22,745.20 were paid during the years 1916 to 1919, inclusive. (There was therefore an operating deficit on March 1, 1913.) Accordingly, the Commissioner reduced invested capital by the amount of these dividends on the ground that they had been paid out of capital. The court approved the determination of the Commissioner for the reason that the taxpayer had not shown that the

operating deficit which had been incurred prior to 1906 had been eliminated at the time the dividends were paid. Thus in this case we see the government taking a position directly opposite to its position before this court and insisting that dividends declared before the elimination of a March 1, 1913 deficit by subsequent earnings are distributions of capital. If the dividends were distributions of capital for invested capital purposes they certainly cannot be simultaneously treated as distributions from earnings or profits taxable to the recipients. Nor do we believe that the government would have taken such an inconsistent position.* We believe that this case demonstrates that at least as late as this decision (1928) the government recognized that a March 1, 1913 deficit had to be restored before there could be any accumulated earnings or profits, regardless of the purpose for which the computation was made.

That this was true for income tax purposes as well as for invested capital purposes is shown by an income tax ruling made in 1927 by the General Counsel of the Bureau of Internal Revenue (G. C. M. 1552, VI-1 CB 10) in which he stated:

*See I. T. 3765, 1945-CB 270, where a corporation had an operating deficit during the years 1936 to 1943 and in each of the years made distributions in amounts not exceeding the current earnings of the respective years which were taxable as dividends. Section 718 (b) (1) of the Internal Revenue Code provides that invested capital must be reduced by distributions made *prior to the taxable year* which are not out of *accumulated earnings or profits*. Nevertheless, it was held that Congress did not intend "to tax distributions as being out of a corporation's earnings or profits and, at the same time, provide for a reduction of equity invested capital by the amount of such distributions as being out of capital."

“The term ‘dividend’ is defined by Section 201(a) of the Revenue Act of 1926 as any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913. Although it is provided in section 201(b) that for the purposes of the Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits, *there can be no accumulation of profits until an operating deficit is made good.* As there was no surplus from which a dividend could have been paid, it necessarily follows that the distribution must have been out of capital.” (Italics added.)

3. The basis of the government’s contention was repudiated by the Supreme Court in the Canfield case.

Fundamentally, the contention now advanced by the government involves the concept that a line is drawn on March 1, 1913 and that a new start is made on that date, everything on the other side of the line being ignored. From this the government concludes that, to determine earnings or profits accumulated since March 1, 1913, it is merely necessary to strike a balance of gains and losses since that date. This is the same contention that was advanced in *Helvering v. Canfield*, 291 U.S. 163 (1934). In that case the company had an earned surplus of \$4,332,684.78 on March 1, 1913. Its fiscal year ended on February 28, and for the year ending in 1914 it had a profit of \$4,594.62, for the year ending in 1915 a loss of \$193,139.67, for the year ending in 1916 a loss of \$211,707.32, and profits thereafter. The question involved was whether the losses of 1915 and 1916 reduced the earned

surplus as of March 1, 1913, or whether they should be carried forward and deducted from profits of years subsequent to 1916 in determining "earnings or profits accumulated since February 28, 1913." The taxpayer contended that for income tax purposes there were two distinct periods, (1) that period prior to March 1, 1913, and (2) that period after March 1, 1913, and that the accumulations for each period constituted "a fixed and static amount, not to be changed by the happenings after the end of the period." He accordingly concluded that the losses of 1915 and 1916 must be deducted from profits of subsequent years in ascertaining earnings accumulated since March 1, 1913. But the Supreme Court refused so to read the statute. The court held that the losses of 1915 and 1916 reduced the earned surplus existing on March 1, 1913 and did not have to be restored by subsequent profits. Thus the "earnings or profits accumulated since February 28, 1913" were determined to be greater than the balance of gains or losses since that date by the amount of the losses which were charged back to the earned surplus as of March 1, 1913. This case therefore conclusively establishes that the concept of the government in the instant case—namely, that it is merely necessary to strike a balance of post-1913 gains or losses in order to determine earnings accumulated since March 1, 1913—is fallacious.

If accumulated earnings as at March 1, 1913 still remain available to absorb subsequent operating losses, then it must certainly follow that an operating deficit as of March 1, 1913 likewise remains available to absorb subsequent

earnings. In order to hold that earned surplus as of March 1, 1913 remained available to absorb losses occurring after that date, the court in the *Canfield* case had to overcome the effect of the statutory provision (section 201(b), Act of 1921) that distributions of pre-1913 earnings may be made exempt from tax after post-1913 earnings have been distributed. But there is no corresponding difficulty in holding that an operating deficit as of March 1, 1913 remains available to absorb subsequent earnings. On the contrary, such a decision is compelled by the fact that to ignore the operating deficit is to tax as income that which in reality is a distribution of capital. That the court in the *Canfield* case would have recognized this impelling reason for reaching the conclusion that a March 1, 1913 operating deficit must be absorbed by subsequent earnings is indicated by the following statement made in answer to the argument that pre-1913 earnings, because of the statutory provision that they could be distributed free of tax, really constituted capital:

“The argument that the surplus of March 1, 1913, constituted capital is unavailing. We are not here concerned with capital in the sense of fixed or paid-in capital, *which is not to be impaired, or with the restoration of such capital where there has been impairment*. No case of impairment of capital is presented.” (Italics added.)

4. The only authorities on the point are contrary to the government's position.

The only case in which this question has been squarely decided is *Chapman v. Anderson*, 11 Fed. Supp. 913 (D.C. N.Y. 1935), but even there the government did not con-

tend that the operating deficit existing on March 1, 1913 did not have to be restored by subsequent earnings,* it merely contended that the deficit *had been eliminated* by unrealized appreciation. In that case a corporation had an operating deficit of \$957,235.15 on March 1, 1913. Subsequent to 1913 it had substantial earnings and it declared three dividends of \$80,000 each on March 2, 1925, July 15, 1925 and January 12, 1926. The plaintiff argued that as of the dates of the two dividends declared in 1925 the deficit as of March 1, 1913 had not yet been completely eliminated by subsequent earnings, and that it was not until the dividend of January 12, 1926 that the deficit as of March 1, 1913 had been completely eliminated, there being on that date a surplus of \$48,845.92. Accordingly, the plaintiff contended that of the three dividends totalling \$240,000 only \$48,845.92 was subject to tax. The government contended that appreciation in value of the corporation's assets as of March 1, 1913 in the amount of \$274,838.97 should be applied in reduction of the operating deficit of \$957,235.15, with the result that such operating deficit would have been eliminated by subsequent earnings prior to the dividend declared on March 2, 1925, and that therefore all three dividends were fully taxable. The court first considered the question as to whether the March 1, 1913 operating deficit had to be restored by subsequent earnings, since if it did not, it was immaterial whether the unrealized appreciation did

*It thus appears that "the long-standing practice of the Bureau to not require that a pre-1913 deficit be eliminated * * *" (Pet. Brief, note 5, p. 26) does not antedate the year 1935. Presumably it originated with the amendment to section 115(a) made in 1936, and discussed *infra*, p. 25 et seq.

or did not reduce the operating deficit. After quoting section 201(a) of the Act of 1926, defining the term "dividend" to mean distributions out of "earnings or profits accumulated after February 28, 1913", the court quotes section 201(d) as follows:

"(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock * * *." (Italics added).*

The court then came to the conclusion that the operating deficit must be restored, stating that

"It seems clear that, unless an operating deficit or impairment of capital has been made good out of subsequent earnings or profits, any distribution of (on) stock is not a 'dividend' under 26 U.S.C.A., paragraph 932, supra." (Italics added.)

Having concluded that the operating deficit as of March 1, 1913 must be restored by subsequent earnings before the corporation could have any accumulated earnings or profits available for dividends, the court considered the second question involved in the case and determined that the March 1, 1913 deficit did not have to be reduced by the unrealized appreciation as of March 1, 1913. Accordingly the court held that of the three dividends totalling

*The court does not comment upon this statutory provision but its significance is plain, viz., if a distribution is not out of earnings or profits it reduces the basis of the stock because it is a capital distribution. Hence there must be earnings or profits in order to have a taxable dividend.

\$240,000 only \$48,845.92 was subject to tax, this being the amount of earnings available after the elimination of the entire operating deficit as of March 1, 1913 by subsequent earnings. The court thus held squarely that the operating deficit as of March 1, 1913 had to be restored by subsequent earnings or profits before there were any *accumulated* earnings or profits available for dividends.*

In referring to *Chapman v. Anderson*, Randolph Paul in "Selected Studies in Federal Taxation, Second Series", states (page 177):

"* * * It was held therein that a write-up of assets in 1925 to reflect their true value as of March 1, 1913, did not constitute 'earnings or profits' *which could be applied to reduce a March 1, 1913, operating deficit so as to render a subsequent distribution taxable as having been made from surplus.*

It cannot be said too often that the question we are discussing is what the statute means, not what Congress might have provided. It might perhaps have provided that a distribution of anything *other than contributed capital* was a dividend. A much more circumscribed purpose appears." (Italics added.)

Again, on page 166:

"It may be * * * it would be constitutional, as intimated in the Cummings case, to treat as dividends all corporate distributions *except distributions of capital contributed by the stockholders.*" (Italics added.)

*It seems clear that the government is in error in asserting (Pet. Brief, p. 28) that "the court entirely missed the significance of what it was deciding, *sub silentio* * * *."

The following statement appears in Mertens "Law of Federal Income Taxation", paragraph 9.30, Volume I, page 463:

"An impairment of capital by an operating deficit accumulated prior to March 1, 1913, must be made good, however, out of subsequent earnings. It is immaterial that although an operating deficit existed at March 1, 1913, the corporation had substantial unrealized increase in value of its properties on that date." (Italics added.)

Paragraph 9.30 of Mertens, in which the foregoing quotation appears, is cited as an authority by the Supreme Court in *Commissioner v. Phipps*, 336 U.S. 410 (1949). In that case the Supreme Court made the following statement (p. 418):

"* * * Briefly stated, in the case of a distribution to a corporation with a deficit for either current or prior losses, the corporation receiving the distribution has no * * * earnings or profits available for current distribution until current income exceeds current losses, *and no accumulated earnings or profits until its actual deficit from prior losses is erased.* See 1 Mertens, Law of Federal Income Taxation, Paragraph 9.30, and cases cited therein, n. 44 et seq. * * *" (Italics added.)

5. Comparison of provisions of earlier statutes shows conclusively that all operating deficits must be restored before earnings or profits are available for dividends.

The following statutory analysis will conclusively demonstrate the correctness of our contention that an operating deficit as of March 1, 1913 must be restored by sub-

sequent earnings before there are any accumulated earnings or profits available for dividends. In the case of *Chapman v. Anderson, supra*, it will be noted that the court quoted section 201(d) of the Act of 1926, which provides that if a distribution by a corporation is not out of increase in value of property accrued before March 1, 1913 *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock. This section of the 1926 Act is identically the same as section 201(d) of the Act of 1924. The Congressional Committee reports on the Revenue Bill of 1924 of both the House and the Senate contain the following explanation of this provision (reprinted in 1939-1 (Part 2) C. B. 250, 274):

“This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* or increase in value of property accrued prior to March 1, 1913 (such as distributions out of unrealized appreciation in value of property or out of depreciation or depletion reserves) *constitute a return of capital* to the stockholders and are taxable to him only if, as, and to the extent that they exceed the basis of his stock.” (Italics added.)

It is apparent from section 201(d) of the 1924 Act and the Congressional explanation thereof that a distribution which is not a distribution of earnings or profits, or increase in value of property accrued prior to March 1, 1913, is a capital distribution which is taxable only if, as, and to the extent that it exceeds the basis of the

stockholder's stock.* Therefore a distribution which is not a distribution of earnings or profits cannot be taxed as a dividend.

In order to answer the foregoing argument the government must of necessity contend that the words "earnings or profits" appearing in the statutory phrase "and is not out of earnings or profits" in section 201(d) of the Act of 1924 and corresponding sections of all succeeding statutes down to 1936 (when the phrase was changed) should be interpreted as though they read "earnings or profits accumulated after February 28, 1913." But the words "earnings or profits" are used without limitation, and it is clear from a consideration of the statute and the Congressional Committee reports referred to that the words "earnings or profits" cannot possibly be construed as though they were followed by the phrase "accumulated after February 28, 1913." However, the following analysis of the dividend provisions of the Revenue Acts of 1921 and 1924 will conclusively demonstrate that the words "earnings or profits", as used in section 201(d) of the 1924 Act and in the Congressional Committee reports explanatory thereof, are used without limitation as meaning all earnings or profits whether before or after March 1, 1913. This analysis will be simplified if the pertinent sections of the Acts of 1921 and 1924 are set forth in parallel columns as follows:

*Section 201(d) of the 1924 and 1926 Revenue Acts was continued in the same form as section 115(d) in the subsequent Revenue Acts, except that in 1936 the phrase "and is not out of earnings or profits" was changed to read "and is not a dividend". This change was necessitated by the change occurring in 1936 in the definition of a dividend to include distributions out of the earnings or profits of the taxable year. See discussion *infra*, p. 25 et seq.

Act of 1921

“Sec. 201. (a) That the term ‘dividend’ when used in this title * * * means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913 * * *.

(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon.

Act of 1924

“Sec. 201. (a) The term ‘dividend’ when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 204.

Act of 1921**Act of 1924**

(No corresponding section.)

(c) Any distribution * * * made by a corporation to its shareholders or members *otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated* or increase in value of property accrued *prior to March 1, 1913*, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee." (Italics added.)

(e) (This relates to distribution in partial or complete liquidation and is not material to this discussion.)

(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 204, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *'' (Italics added.)

Turning our attention first to the foregoing provisions of the Act of 1924, it will be seen that subsection (a) deals with earnings or profits accumulated after February 28, 1913, and provides that they shall constitute taxable dividends. A portion of subsection (b), which we shall call subsection (b-1), deals with distributions from earnings or profits accumulated before March 1, 1913, and provides that such distributions will reduce the basis of the stock. The remainder of subsection (b), which we shall call subsection (b-2), deals with distributions from increase in value of property accrued before March 1, 1913, and provides that such distributions will reduce the basis of the stock. Subsection (c) deals with distributions in partial or complete liquidation.

Subsection (d) then provides that if a distribution does not come within any of the previous subsections, namely, subsections (a), (b-1), (b-2), or (c), then the distribution will reduce the basis of the stock. It accomplishes this in the following manner:

It first disposes of subsection (c) by stating that the distribution is "not in partial or complete liquidation". It then disposes of subsection (b-2) by stating that the distribution is "not out of increase in value of property accrued before March 1, 1913". It then disposes of subsection (b-1), relating to earnings or profits accumulated *before* March 1, 1913, and all of subsection (a), relating to earnings or profits accumulated *after* February 28, 1913, by providing that the distribution is "not out of earnings or profits."

Congress in subsection 201(c) of the 1921 Act, in stating that if a distribution was not covered by subsections (a) and (b) of that Act it would reduce the basis of the stock, repeated subsections (a) and (b) literally. But in subsection (d) of the 1924 Act Congress deliberately changed the language of the corresponding section of the 1921 Act (subsection (c)), and instead of stating that if a distribution was not out of *earnings or profits accumulated since February 28, 1913*, and was not out of *earnings or profits accumulated before March 1, 1913*, it would reduce the basis of the stock. Congress stated that if the distribution was not out of *earnings or profits* it would reduce the basis. This is conclusive proof that the words "earnings or profits" are used without limitation in subsection (d) of the 1924 Act and mean earnings or profits whenever acquired, either before or after March 1, 1913.

It follows, therefore, that if Oceanic had declared a dividend prior to its liquidation, for example, in 1935, this dividend under the applicable provisions of section 115(d) of the Act of 1934 (identically the same as section 201(d) of the Act of 1924) would clearly have been a distribution of capital specifically required by the statute to be applied in reduction of the basis of the stock, since it would not have been a distribution of earnings or profits* nor a distribution out of increase in value of property accrued before March 1, 1913. Being a distribution of capital to be applied in reduction of the basis of the stock, it could not at the same time have been a dividend as defined by section 115(a). It is clear, therefore, that unless a corporation has "earnings or profits" it cannot have "earnings or profits accumulated after February 28, 1913".

6. The addition in 1936 of Part (2) of the definition of a dividend does not change the meaning of Part (1).

The government may argue that the foregoing statutory analysis is entirely beside the point because the Internal Revenue Code was in effect in 1939 and 1940 when the dividends in question were declared by the Spreckels Company, and section 115(d) of the Internal Revenue Code, as well as section 115(d) of the 1936 Act when Oceanic was liquidated, both change the phrase "and is not out of earnings or profits" to read "and is not a dividend", so that the pertinent portion of the section then read:

*Except to the extent of the small amount of earnings or profits which might then have been on hand after eliminating the deficit as of March 1, 1913.

“(d) Other Distributions From Capital.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock * * *.”

The change in the wording of this section was necessitated by the change in the definition of a dividend made by section 115(a) of the Act of 1936. This section (115(a)) added a new provision to the definition by which distributions from the earnings or profits of the taxable year were subjected to tax without regard to the existence of an operating deficit at the beginning of the year. Since a stockholder's basis should not be reduced if he was subjected to tax on the distribution, it was necessary to make the foregoing change in section 115(d). After the change made in 1936 the pertinent portion of the definition of a dividend, as contained in section 115(a) of the Act of 1936 and the Internal Revenue Code, read as follows:

“(a) Definition of Dividend.—The term ‘dividend’ when used in this title . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.”

The change consisted of the addition of Part (2) to the definition. Why was this change made? The answer is

found in the provisions relating to the new surtax on the undistributed profits of corporations first imposed by the Act of 1936,* which, in the computation of the annual undistributed net income upon which the tax was imposed, allowed a credit only for dividends paid which were taxable in the hands of the recipient. Accordingly, a corporation which had no earnings or profits available for dividends would find itself subject to this new surtax even though it distributed all of its current earnings, since such distributions would not be taxable to the recipients (see *Foley Securities Corp. v. Commissioner*, 106 F.2d 731, CCA 8, 1939). The purpose of the change in the definition of a dividend was to avoid this inequitable result, as explained in the report of the Senate Finance Committee relating to the Act of 1936, and reprinted in 1939-1 (Part 2), C. B. page 689, as follows:

“In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends-paid credit for the purposes of the undistributed-profits surtax, section 115(a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends-paid credit to the corporation. *As respects such dividends* the complicated determination of accumulated earn-

*This tax, which was designed to force corporations to distribute their profits by placing a graduated tax on undistributed income, proved to be impracticable and was abandoned, there being no similar tax enacted with the succeeding Revenue Act in 1938.

ings or profits is rendered unnecessary.” (Italics added.)

Thus the change in the definition of a dividend which was made in 1936, which change is contained in Part (2) of the definition, can have no possible effect upon the meaning of the preceding words in Part (1) of the definition which had remained unchanged ever since the Revenue Act of 1916. The change merely resulted in subjecting to tax distributions out of the earnings or profits of the current year if such distributions are made *within the year*. No problem of accumulated earnings or profits is involved. Since the change in 1936 a dividend is payable first out of the earnings or profits of the current year, but if there are no such profits, or if the distribution exceeds such profits, then recourse must be had to “earnings or profits accumulated after February 28, 1913”—and when this point is reached, it is our contention that the amount of such earnings or profits are necessarily ascertained in the same manner as they would theretofore have been ascertained under each of the Revenue Acts beginning with the Act of 1916. Certainly it cannot be assumed that Congress, having used the identical words, intended to change their meaning.

C. THE GOVERNMENT'S CONSTRUCTION RAISES THE QUESTION OF CONSTITUTIONALITY OF THIS SECTION AS APPLIED TO THE FACTS OF THIS CASE.

The foregoing statutory analysis has demonstrated beyond question that the correct interpretation of the words “earnings or profits accumulated after February 28,

1913'' is that first, there must be earnings or profits, and secondly, in the computation of earnings or profits all earnings or profits accumulated prior to March 1, 1913 are to be eliminated.* The construction contended for by the government immediately raises the question of constitutionality. It is our contention that section 115(a) of the Internal Revenue Code is unconstitutional if it is construed to impose an income tax upon distributions which are in excess of current earnings and where the corporation has no accumulated earnings or profits. Under such circumstances it is our contention that any distribution is a return of capital and therefore not within the terms of the Sixteenth Amendment to the Constitution granting to Congress the power ''to lay and collect taxes on incomes * * *'', and accordingly a tax violative of Section 2 of Article I of the Constitution as being a direct tax not apportioned among the several states. (*Pollock v. Farmers Loan & Trust Co.*, 157 U. S. 429 (1895).)

We note that the government does not believe that the construction of the statute for which it contends raises a constitutional question, apparently relying on the fact that the validity of the amendment made in 1936 taxing distributions from current earnings, even though a deficit in accumulated earnings or profits may exist, has never been questioned. But we are of the opinion that, in so far as constitutionality is concerned, a distinction may well be drawn between the taxation of distributions made from current earnings within the same year that such earnings are realized, and distributions which exceed such current

*Except to the extent that they are absorbed by subsequent losses as held in the *Canfield* case, *supra*.

earnings and made at a time when there are no accumulated earnings to which resort may be had. Consideration was given to this problem at the time of entering into the Stipulation of Facts upon which these cases were tried below, and the three firms of attorneys then representing the various stockholders concluded not to contest the imposition of the tax with respect to dividends declared by the Spreckels Company out of its current earnings for the years involved, but only to contest the taxation of distributions which exceeded current earnings. This conclusion was based upon the conviction that the correct analysis of the statutory provisions involved leads irresistibly to the conclusion that unless a corporation has "earnings or profits" it cannot have "earnings or profits accumulated after February 28, 1913". Thus under the issues as tried no constitutional question would arise.

D. CORRECTION OF MISCELLANEOUS ARGUMENTS IN GOVERNMENT'S BRIEF.

1. This case does not involve a claim for exemption from tax.

The government contends that the taxpayers here are claiming an exemption from tax, and refers to the well-known principle that exemptions are to be strictly interpreted and the taxpayer "must show that he has plainly been touched by the legislative grace" (Pet. Brief, pp. 15-21). The taxpayers here are not claiming that they are exempt from the tax, nor that their incomes are exempt from the tax. They are not asking for special treatment in any respect, so that it could be said that they claim to have been "touched by the legislative grace." They are

merely contending that Congress did not intend to levy a tax on a return of capital.

2. The Tax Court's decision does not render any words in the statute meaningless.

The government in its brief argues that to construe the statute as the Tax Court has done in its decision in this case is to render completely meaningless the words "accumulated after February 28, 1913". It is stated that in so limiting the definition of a dividend Congress could not have been seeking to protect a pre-1913 surplus from being taxed as a dividend when distributed because such protection is provided by section 115 (b). (Pet. Brief, pp. 12-13.) There are two answers. First, when a dividend was first defined in the 1916 Act (section 2(a)) that Act contained no section corresponding to section 115 (b). Such a section was first added in 1917 (section 31 (b) of the 1916 Act, as added by section 1211 of the 1917 Act). Secondly, if section 115 (a) read that "the term dividend means any distribution by a corporation out of its earnings or profits", it would necessarily mean that all dividends from earnings or profits are subject to tax, and this would needlessly conflict with section 115 (b) which exempts from tax distributions of pre-1913 earnings.

3. Government's quotation from *Foster* case is misleading.

The quotation from *Foster v. United States*, 303 U. S. 118, set forth on page 19 of the government brief, is misleading unless read in the light of the obviously tax-dodging scheme under consideration by the court. In that case a family corporation redeemed 25% of its stock by paying \$1,025,000 therefor, and some months thereafter

declared a dividend of \$225,000. The contention was advanced that this dividend was subject to tax only to the extent of the small amount of earnings accruing to the corporation between the date of the redemption of the stock and the date of the dividend. At the time of the redemption of the stock the corporation had undistributed earnings in the amount of \$333,578.98, far in excess of the subsequent dividend, but the plaintiff argued that this amount was completely eliminated by the statutory provision (section 115(b), Act of 1928) that "every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits." Plaintiff then relied upon the further provision of the same section of the statute that earnings or profits accumulated before March 1, 1913 may be distributed exempt from tax after earnings and profits accumulated after February 28, 1913 had been distributed. The Supreme Court held that the payment made in redemption of the stock was not a distribution of earnings or profits within the meaning of the statute, and the language quoted in respondent's brief merely expresses the court's opinion of this scheme to avoid taxation.

E. THE CASES PRIMARILY RELIED UPON BY THE
GOVERNMENT ARE NOT IN POINT.

The government has misinterpreted the decision of the Court of Appeals for the Second Circuit in *Hadden v. Commissioner*, 49 F.2d 709 (1931). Because of the great importance which the government attaches to this case (Pet. Brief, pp. 25-26) it will be necessary to examine

the facts and the decision in some detail. The case was tried before the Board of Tax Appeals with the companion case of *Annie P. Kountze*, 17 B. T. A. 928, and the *Hadden* case (which is reported at 17 B. T. A. 956) refers to the *Kountze* case for the facts relating to the dividend issue. Thus the facts here set forth are contained in either the *Kountze* case or the Court of Appeals decision in the *Hadden* case. United Thacker Coal Co. was organized in 1903 and in January 1904, acquired approximately 56,000 acres of undeveloped coal lands which it continued to own until the latter part of 1917. It did not remove and sell any coal and between 1904 and 1917 the company had very little income but did have substantial expenses, with the result that at March 1, 1913 it had a deficit in excess of \$500,000. From that date until April 30, 1917 it sustained an operating loss amounting to \$329,549.22. Between April 30, 1917 and December 22, 1917, the date the dividends in question were declared, it realized a profit of \$735,300 from the sale of some of these coal properties, which profit was calculated on March 1, 1913 values. There were other expenses during the period from April 30 to December 22, 1917 amounting to \$329,350.91, so that the net income before taxes was \$405,949.09. Subtracting accrued income taxes in the amount of \$54,550.28 leaves a net income for the period April 30, 1917 to December 22, 1917 of \$351,398.81.

On the foregoing facts the taxpayers contended before the Board of Tax Appeals in the *Hadden* case that since the net income of \$351,398.81 was considerably less than the March 1, 1913 deficit plus the losses thereafter occurring up to April 30, 1917 in the amount of \$329,549.22,

it followed that there could be no earnings or profits accrued since March 1, 1913. But in a decision reviewed by the Board without dissent the Board pointed out that the petitioners' computation of earnings or profits available for dividends was based on the use of March 1, 1913 values and that whereas this method was proper for the determination of income subject to income tax, in ascertaining whether over a corporation's entire life it has earnings or profits available for dividends the computation must be based on cost. In this connection the Board said (17 B. T. A. 931):

“* * * The petitioner contends that at the time of the distribution, the company had no surplus or undivided profits of any kind. The facts in evidence fail to support this contention, as is demonstrated by a proper computation to arrive at the correct surplus, if any, of the corporation on December 22, 1917. In such computation the profit from the sale of property determined by the use of March 1, 1913, value which was in excess of cost, should not be used alone to offset deficits which occurred *both before and after March 1, 1913*, because the statute contains no provision for the use of March 1, 1913, value in this connection. On the contrary, the profit from the sale in 1917 which should be used to offset operating deficits occurring *both before and after March 1, 1913*, in computing the correct surplus of the company on December 22, 1917, should be determined by using the cost of the property sold. In this way only can we determine whether or not on December 22, 1917, the corporation had any surplus or undivided profits available for the payment of dividends.

“We can not make such a computation in the present case because we do not know the cost of the

property sold. For example, if it had cost only \$2,000,000, the correct book profit from the sale which should be used in wiping out *all past operating deficits* would be far more than sufficient for the purpose. * * *'' (Italics added.)

Although it is clear from the foregoing extract that the Board was of the opinion that there could be no earnings or profits available for dividends until all past operating deficits had been wiped out, including the deficit as of March 1, 1913, nevertheless the Board concluded that it was unable to determine from the record that the Commissioner had erred in holding that certain portions of the distribution received from the coal company in 1917 by Luther Kountze (for whom Hadden was executor) were taxable to him. The reason given by the Board for being unable to determine this question was that the record failed to disclose the number of shares outstanding at the date of the dividend.

An appeal was taken by the taxpayer in the *Hadden* case to the Court of Appeals for the Second Circuit, but apparently no appeal was taken in the *Kountze* case. There were other issues involved in the case but in so far as the dividend issue was concerned the taxpayer made no contention before the Court of Appeals that the deficit on March 1, 1913 had not been restored, but after setting forth the figures discussed above with respect to gains and losses thereafter realized he contended that from the net income of \$351,398.81 for the period April 30, 1917 to December 31, 1917 there should be deducted the losses realized from March 1, 1913 to April 30, 1917 in the amount of \$329,549.22, leaving an amount available

for dividends on December 22, 1917 of \$21,849.59. Luther Kountze's share* of this was \$6,086.64, which the taxpayer contended was the amount of the taxable distribution received. Bearing in mind that the tax on this amount at 1917 rates would be very low (in fact it would not exceed \$500 if we assume the taxpayer's income did not exceed \$100,000), it is apparent that rather than attempt to prove the original cost of all the property sold in 1917 the taxpayer had concluded to abandon the argument that the deficit as of March 1, 1913 had not been fully restored. In ascertaining the earnings or profits which had accrued since 1913 it is proper to use March 1, 1913 values and accordingly the taxpayer was able to demonstrate that the amount involved was so small as not to warrant the expense of establishing original cost, particularly in view of the fact that the books of the corporation had been destroyed by fire in 1912. On the other hand, the Commissioner had nothing to gain by attempting to increase earnings or profits over the corporation's entire life by reducing original cost since the increase would merely represent an increased realization of March 1, 1913 appreciation and consequently tax free when distributed (section 115(b)). Thus before the Court of Appeals both parties agreed to take the position that the dividend issue could be determined by taking into consideration only the gains and losses realized since March 1, 1913. The Court of Appeals agreed with the taxpayer's position that the taxable dividend which he

*On the appeal the Commissioner stipulated with respect to the number of shares outstanding at the date of the dividend and accordingly this cured the defect in the record which prevented the Board from arriving at the same conclusion as the Court of Appeals.

had received was \$6,086.64. It is apparent that the language quoted in the government brief must be read in the light of the fact that the only matter before the court, in so far as the dividend issue was concerned, was the ascertainment of the earnings or profits of the corporation for the period March 1, 1913 to December 22, 1917. In considering this question the court pointed out that there must be subtracted from the 1917 profits on the sale of land the losses sustained between March 1, 1913 and April 30, 1917, and it was in support of this proposition that the Tax Court cited the case (R. 76). It is clear, therefore, that the government erred in stating that the case stands for the "exact opposite" of the proposition for which it was cited by the Tax Court. The government was also in error in stating that the Tax Court overlooked completely the fact that the Circuit Court did not deduct the \$500,000 deficit as of March 1, 1913, and that "the Tax Court's reasoning embodies a patent *non-sequitur*". (Pet. Brief, pp. 25-26).

The government also relies on *Hoffman v. United States*, 53 F.2d 282 (Ct. Cl. 1931), as a case in which the court assumed that a March 1, 1913 deficit did not have to be restored by subsequent earnings before there could be earnings or profits available for dividends. However, the decision of the Court of Claims in this case, which involved the taxability of a dividend declared in 1917, was based on a prior decision of that court in *Blair v. United States*, 63 Ct. Cl. 193 (1927), which held that a dividend paid in 1918 out of the current earnings of a corporation was taxable even though such current earnings were less than an operating deficit at the

beginning of the year. In the *Hoffman* case the Court of Claims had the same question before it, although the facts were somewhat more complicated, and followed the *Blair* case in holding that current earnings are subject to tax when distributed irrespective of prior operating deficits even though incurred since 1913. This explains its dictum quoted on page 27 of the government brief that if the profit of 1913 had been distributed in 1913, the distribution would have been taxable notwithstanding the existence of a prior operating deficit.

The Court of Claims was, however, in error in its conclusion that current earnings are subject to tax when distributed irrespective of a prior operating deficit, and it has since become well established that the prior operating deficit must be restored before there are accumulated earnings available for dividends. See for example *Foley Securities Corp. v. Commissioner* (C.C.A. 8, 1939), 106 F.2d 731; *Hadden v. Commissioner*, *supra*; *J. L. Washburn*, 16 B.T.A. 1091 (1929); G.C.M. 1552, VI-1 C. B. 10.

In *Foley Securities Corp. v. Commissioner*, *supra*, Judge Sanborn, speaking for the Circuit Court of Appeals for the Eighth Circuit, says, 106 F.2d 733:

“The taxpayer contends that, in computing the surtax, the Commissioner should have deducted, as a dividend, from its ‘adjusted net income’ the entire \$42,375 which it had distributed to its shareholders. In support of this contention it cites *Blair v. United States*, 63 Ct. Cl. 193, certiorari denied 275 U. S. 546, 48 S. Ct. 84, 72 L. Ed. 418, which, in effect, held that a distribution to shareholders out of current earnings was a ‘dividend’, although the capital of

the corporation was impaired at the time the distribution was made. The Board of Tax Appeals has expressly refused to follow the Blair case (*Washburn v. Commissioner*, 16 B.T.A. 1091, 1098; *Shorb v. Commissioner*, 22 B.T.A. 644, 645), relying in part upon *Willcuts v. Milton Dairy Co.*, 275 U. S. 215, at page 218, 48 S. Ct. 71, at page 72, 72 L. Ed. 247, in which the Supreme Court said: 'But it is a prerequisite to the existence of "undivided profits" as well as a "surplus," that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute "undivided profits."' The Supreme Court also held in that case that the words 'undivided profits,' as commonly understood, describe such part of the excess in value of the corporate assets as consisted of profits which had neither been distributed as dividends nor carried to surplus account.'

In explaining its refusal to follow the *Blair* case, the Board of Tax Appeals in *J. L. Washburn*, supra, stated that

"* * * The interpretation there placed upon *Edwards v. Douglas*, 269 U. S. 204, cited by the Court of Claims in support of its decision, can not be sustained in the light of the Supreme Court's decision in *Willcuts v. Milton Dairy Co.*, supra."

The decision of the Board of Tax Appeals in *J. L. Washburn*, supra, was written by its then Chairman, Judge Littleton, and was approved by the entire Board on this point. At the time of the decision of the Court of Claims in the *Hoffman* case, Judge Littleton had be-

come a member of the Court of Claims and wrote an opinion dissenting in part. Judge Littleton, of course, refused to agree with the opinion of the majority that current earnings are taxable when distributed irrespective of the existence of a prior operating deficit. The majority being of the opinion, as we have stated, that no prior deficits need be restored, did not separately consider and pass upon the question as to whether or not the deficit existing as of March 1, 1913 in that case need be restored. Judge Littleton, since he was of the opinion that prior deficits must be restored, did have to give consideration to the operating deficit which existed at March 1, 1913. In referring to the earnings for the period March 1, 1913 to December 31, 1913 he makes the statement that "this amount is insufficient to make up the deficit existing March 1, 1913, *and thus create a surplus from which a dividend might be declared * * *.*" (Italics added.)

After analyzing the accounts down through 1917 and adjusting for the difference between depletion on March 1, 1913 values and depletion on cost, Judge Littleton finds that there were sufficient earnings to cover all dividends declared *after restoring the March 1, 1913 deficit* and that it was, therefore, unnecessary to take this deficit into account in the computations which are set forth in his opinion. Both the majority opinion and Judge Littleton's opinion contain tables showing the computation of earnings available for dividends subsequent to March 1, 1913, and in order to keep his computation on a basis comparable to the computation contained in the majority opinion, Judge Littleton did not desire to inject into his

computation the restoration of the deficit existing on March 1, 1913 unless this was necessary. In his opinion Judge Littleton said:

“ * * I have not considered the deficit existing at March 1, 1913, for the reason that at all times there was a surplus sufficient to extinguish the deficit and pay the dividend. A dividend can, of course, only be paid when a surplus exists, * * *.”* (Italics added.)

Thus the majority of the court in the *Hoffman* case gave no consideration to the question as to whether or not a March 1, 1913 deficit should be restored and this case can only be cited for the proposition, previously decided by the Court of Claims in the *Blair* case, that no prior deficit need be restored, even deficits which have been incurred since March 1, 1913. As we have seen, this proposition has since been discredited.

CONCLUSION.

It has been shown that the construction of the statute contended for by the government will lead to an economic absurdity in the instant case. It is also clear that this construction of the statute necessarily results in taxing as a dividend that which in actuality is a distribution of capital, thereby raising a constitutional question. It is accordingly apparent that such a construction of the statute should not be adopted unless no other construction is possible. But we have shown, we believe, that such a construction is not only contrary to well-recognized principles of corporation law which require that impaired capital be restored before there can be earnings or profits

available for dividends, but is also contrary to the construction which must be given to the statute if consideration be given to its historical development as set forth herein. Such consideration conclusively establishes that an operating deficit existing on March 1, 1913 must be offset by subsequent earnings or profits before there can be "earnings or profits accumulated after February 28, 1913."

The decision of the Tax Court of the United States should be affirmed.

Dated, San Francisco, California,
March 7, 1951.

Respectfully submitted,
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12,663.*

(Appendix Follows.)

Appendix.

Appendix

Revenue Act of 1916, c. 463, 39 Stat. 756:

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

Revenue Act of 1917, c. 63, 40 Stat. 300:

Sec. 1211. That Title I of such Act of September eighth, nineteen hundred and sixteen, is hereby amended by adding to Part III six new sections, as follows:

* * * * *

Sec. 31. (a) * * *

(b) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen.

* * * * *

Internal Revenue Code:

Sec. 115. Distributions by Corporations.

(a) Definition of Dividend.—The term “dividend” when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed

as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) Source of Distributions.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(d) Other Distributions from Capital.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

(Sections 115 (a) and (b) are identically the same, and section 115 (d) is in all material respects the same, under the Revenue Acts of 1938 and 1936.)

